Methodology

Rating U.S. FFELP Student Loan Transactions

OCTOBER 2006

Operational Risk Review section updated in methodology entitled "Operational Risk Assessment for U.S. ABS Servicers" in June 2011

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CONTACT INFORMATION

U.S. STRUCTURED FINANCE

Claire J. Mezzanotte
Managing Director
U.S. Structured Finance - ABS/RMBS/Covered Bonds
Tel. +1 212 806 3272
cmezzanotte@dbrs.com

Chris O'Connell
Senior Vice President
U.S. Structured Finance - ABS
Tel. +1 212 806 3253
coconnell@dbrs.com

Chris D'Onofrio
Senior Vice President
U.S. Structured Finance - ABS
Tel. +1 212 806 3284
cdonofrio@dbrs.com

Chuck Weilamann
Senior Vice President
U.S. Structured Finance - ABS
Tel. +1 212 806 3226
cweilamann@dbrs.com

U.S. STRUCTURED FINANCE - OPERATIONAL RISK

Kathleen Tillwitz
Senior Vice President
U.S. Structured Finance - ABS/RMBS/Covered Bonds
Tel. +1 212 806 3265
ktillwitz@dbrs.com

Stephanie Whited
Vice President
U.S. Structured Finance - ABS/RMBS/Covered Bonds
Tel. +1 347 226 1927
swhited@dbrs.com

U.S. STRUCTURED FINANCE - RESEARCH, MODELING AND SURVEILLANCE

Jan Buckler
Senior Vice President
U.S. Structured Finance - ABS/RMBS/Covered Bonds
Tel. +1 212 806 3925
jbuckler@dbrs.com

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Rating U.S. FFELP Student Loan Transactions

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Executive Summary

Federal Family Education Loan Program (FFELP) loans have become one of the U.S. capital markets most prevalent and reliable sources of collateral for asset-backed securities (ABS). This is a function of the stable performance of FFELP loans and ongoing increases in origination volume. DBRS outlines its rating methodology for ABS backed by FFELP loans in this report.

The FFELP Program

The FFELP is the U.S. government's largest higher education financial aid program. FFELP loans require minimal underwriting and are guaranteed by eligible guarantee agencies, usually state-sponsored, not-for profit entities, and reinsured by the U.S. Department of Education (ED) for at least 97%[1] of defaulted principal and accrued interest.

To qualify for a FFELP loan, a student must be enrolled in at least a half-time program of study at an eligible Title IV institution.[2] These institutions include two-year, four-year, graduate and professional schools, as well as proprietary and vocational training institutions. The FFELP program offers a variety of loan products, each with distinct objectives and loan terms. Key FFELP loan types are summarized in Table 1 below.

Table 1

	Borrowers	Interest Subsidies	Interest Rate		Loan Term
Stafford	Undergraduate and Graduate Students	During in-school, grace and deferment statuses for borrowers meeting a "needs test"	Pre-July1, 2006: variable with annual reset	Post-July 1, 2006: fixed 6.8%	10–25 years
PLUS	Parents of under-graduate students	None	Pre-July1, 2006: variable with annual reset	Post-July 1, 2006: fixed 8.5%	10–25 years
Grad PLUS	Graduate students	None	Pre-July1, 2006: variable with annual reset	Post-July 1, 2006: fixed 8.5%	10–25 years
Consolidation	Any FFEL borrower	Only on portion of loan stemming from subsi-dized Stafford loan(s)	Fixed at the weighted average rate of the underlying FFELP loans		Up to 30 years

The payment terms of FFELP loans are governed by federal regulations and are impacted by the various defined loan statuses. For example, interest rates on FFELP loans vary depending on whether the borrower is in school or grace status, has graduated, or is no longer enrolled in at least a half-time program of study. The FFELP provides for the following:

- Grace periods of up to six months for Stafford borrowers prior to entering active repayment and 60 days to PLUS borrowers following loan disbursement.
- Deferment for borrowers returning to post-graduate studies.
- Forbearance for borrowers experiencing economic hardship.

1. 97% for loans originated after July 1, 2006; 98% or 100% for loans originated prior to July 1, 2006.
2. There are various parameters, including a school's historical cohort default rate, which must be met for a school to qualify as a Title IV institution.

In order for loans to qualify for guarantees, FFELP loans must be properly originated and serviced by eligible lenders and servicers in accordance with the federal regulations and industry guidelines. Errors in origination or servicing may result in the rejection of defaulted loan claims by guarantors and shift 100% of the liability for losses to the loan holder.[3]

The servicing procedures for FFELP loans are dictated by a set of industry guidelines that represent procedures to which servicers must adhere in order to retain the guarantee. These procedures are outlined in the *Common Manual: Unified Student Loan Policy* (*Common Manual*).[4]

FFELP loans are typically originated by commercial banks and finance companies. To fund disbursements to borrowers, originators typically use either their own balance sheets or third-party warehouse facilities that are often funded through asset-backed commercial paper vehicles.

Transaction Structure

Transactions backed by FFELP loans may be either traditional asset securitizations or pledged financings (i.e., linked to a sponsoring entity and analogous to a secured corporate financing). In a traditional securitization, assets are transferred via a true-sale mechanism to a bankruptcy remote, special-purpose entity. This mechanism ensures that the trust collateral cannot be consolidated into the seller's estate in the event of a bankruptcy. Legal opinions are rendered to indicate the transfer was affected via a true-sale mechanism. In pledged financings, although no true-sale occurs, legal opinions are provided to indicate that: (1) the activities of the seller/originator, which is often a not-for-profit entity, are such that insolvency is a remote possibility,[5] and (2) the student loan assets should not be consolidated into the seller/originator's estate even in the event of a bankruptcy. For the remainder of this report, the term securitization encompasses FFELP loan transactions executed as either traditional asset securitizations or pledged financings.

FFELP loan transactions typically contain one or more forms of debt types, including auction-rate securities, variable-rate demand obligations, floating-rate notes or fixed-rate notes. Transactions typically are credit enhanced through senior/subordinate capital structures, with reserve accounts and excess spread providing additional loss protection. Transactions generally have the following structural features:

- Owner trust versus master trust form
- Senior/subordinate capital structure
- Sequential pay structure with or without step-down date
- Excess spread and premium proceeds structure
- Floor income
- Reserve and/or capitalized interest accounts
- Note triggers
- Prefunding periods
- Recycling periods

3. Loan holders are either originators or purchasers of student loans who hold the loans on their balance sheets or special purpose entities (e.g., trusts) into which loans have been sold for securitization.
4. The *Common Manual* is a set of servicing procedures that are generated and revised by the nation's FFELP guarantors.
5. Not-for-profit entities in the FFELP loan market are often state agencies or quasi-state agencies whose business purposes are narrowly defined and usually limited to buying and selling student loans. Also, these entities often have limited discretion in their ability to issue corporate debt.

OWNER TRUST VERSUS MASTER TRUST STRUCTURE

FFELP loan securitizations utilize either an owner trust structure, in which the collateral pool is discrete or amortizing, or a master trust structure, in which the collateral pool is revolving. Issuers choose between these structures for a variety of reasons, including the comparative costs of creating new discrete trusts versus continuing to issue out of a revolving master trust, the ability to segregate or commingle collateral types, and the ability to more precisely establish the value of the residual interest in a transaction.

SENIOR/SUBORDINATE CAPITAL STRUCTURE

FFELP loan securitizations often have capital structures that include multiple senior, highly rated classes of notes along with one or more classes of subordinate notes. Subordinate notes usually represent 3% to 10% of the capital structure and serve as the primary source of credit enhancement for the senior notes. Credit ratings on subordinate note classes have typically been investment grade, ranging from AA to BBB. In some structures, subordinate notes are issued as auction-rate securities to help absorb collateral prepayments and serve to reduce prepayment risk for senior term note investors.

Senior notes are often "time tranched" (i.e. tranched out by weighted-average life (WAL)) in order to meet the bond maturity/duration targets for various investors. The WALs of senior note classes tend to range from one to fifteen years or more, while the WALs of subordinate notes tend to range from eight to fifteen years.

SEQUENTIAL PAY WITH OR WITHOUT STEP-DOWN DATE

In most FFELP loan securitizations student loan principal and interest collections are commingled and distributed as available funds through one cash flow payment waterfall in a sequential pay structure.

Payments to transaction constituents are typically allocated in the following order of priority:

(1) Servicing and administrative fees.

(2) Interest to senior noteholders.

(3) Interest to subordinate noteholders.

(4) Principal to senior noteholders, sequentially.

(5) Principal to subordinate noteholders.

(6) To replenish the reserve account to meet the minimum required balance.

(7) For transactions that include a revolving period, purchase of new collateral.

(8) Release of remaining available funds to the residual certificate holder if certain parity[6] ratios are met.

In some FFELP loan securitizations, principal payments to noteholders are limited to the amount of principal collections received from the collateral pool during the period. In these structures, the amount of available funds that can be used to amortize note principal is generally referred to as the **principal distribution amount**. This amount includes scheduled borrower payments, involuntary borrower prepayments and guarantee reimbursements on defaulted loans[7] (see Appendix B – Illustration of Calculation of Principal Distribution Amount).

6. Parity is a measure of the trust's assets to liabilities. "Total parity" refers to the measure of the trust's assets to the trust's total liabilities. "Senior parity" refers to the measure of the trust's assets to the trust's senior liabilities.
7. However, if certain parity tests are failing, interest proceeds or excess spread can also be used to amortize notes.

STEP-DOWN DATE

In order to provide senior investors with additional protection from collateral defaults, some FFELP loan securitization structures pay note principal sequentially and "lock out" principal to subordinate notes prior to the step-down date. Step-down dates are usually set to occur at distribution dates approximately five to seven years after closing. After the step-down date occurs, the payment structures switch to pro rata pay. However, if certain triggers are breached, subordinate note principal payments are redirected to pay additional senior note principal to de-lever the transaction until 100% total parity is restored. Frequently, in FFELP securitizations, triggers that "lock out" subordinate note principal after a step-down date are tied to maintaining specified parity levels.

After the step-down date, when principal payments may switch from sequential to pro rata amongst senior and subordinate note classes, most structures require the portion of senior note principal to continue to pay sequentially within the senior note classes. This circumstance creates the possibility for a subordinate note class to pay down faster than a longer dated senior note class and, therefore, have a longer payment window than the longer dated senior note class and a lower WAL.

EXCESS SPREAD

Similar to other ABS transactions, FFELP loan securitizations rely on transactions' excess cash flows, or "excess spread", as one form of credit enhancement. For subordinate notes, this is the primary source of credit enhancement. Excess spread is the difference between the interest collected on the collateral (net of various fees and expenses) and noteholder interest payments. Excess spread is used to cover shortfalls in note interest and principal payments and is often retained in the early years of transactions to help trusts reach 100% parity, or targeted overcollateralization levels.

The levels of excess spread in FFELP loan transactions can vary based on: (1) the loan types included in the underlying collateral pool; (2) the type of debt issued by the trust; (3) the servicing and administrative costs included in the transaction; and (4) the use and effectiveness of hedging instruments to offset interest rate or basis risk.

Certain features of FFELP loans create stability in the levels of excess spread generated in FFELP loan securitizations. These features include: (1) government interest subsidies on subsidized Stafford loans and the subsidized portion of Consolidation loans when borrowers are in in-school, grace, or deferment statuses; (2) quarterly special allowance payments (SAP) from the government to loan holders in rising interest rate environments to ensure that loan holders receive a "market rate of return"; and (3) on loans disbursed prior to April 1, 2006, loan holders may benefit from floor income in declining interest rate environments (see Floor Income section below).

PREMIUM PROCEEDS STRUCTURE

Often, FFELP loan securitizations have parity ratios of less than 100% at closing. This situation occurs when securitization proceeds are used to cover transaction costs or when collateral is acquired at a premium. DBRS permits parity ratios of less than 100% at closing because of the ability of FFELP loan trusts to build parity to, and in excess of, 100% over time. Trusts are able to build parity due to: (1) low losses realized in FFELP portfolios; (2) the ability of trusts to generate stable levels of excess spread; (3) the release of excess available funds often being contingent upon trusts maintaining parity levels of not less than 100.0%; (4) the frequent use of "lock out" periods for subordinate note principal payments (see Step Down section above); and (5) the capitalization of deferred loan interest that results in larger loan principal balances at repayment.

FLOOR INCOME

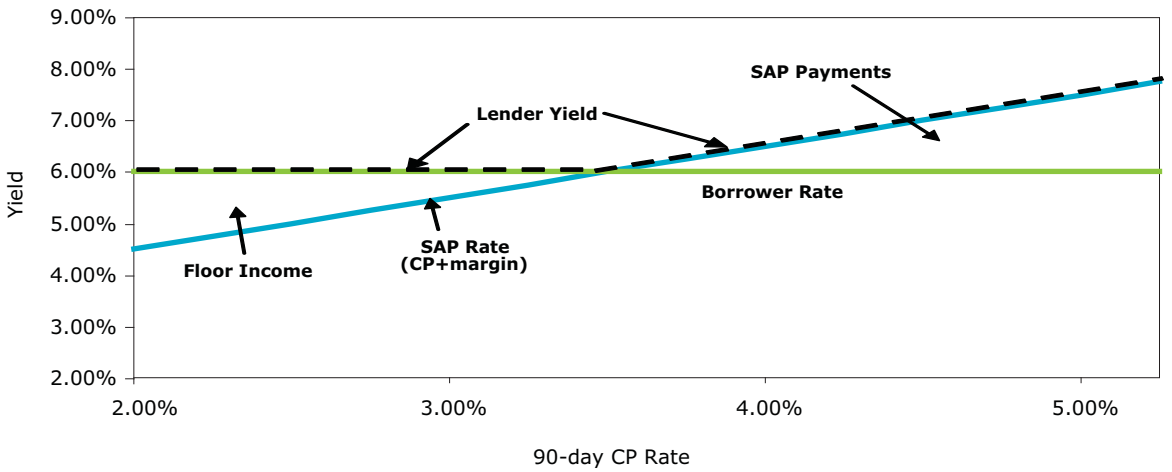
Borrower rates can be either fixed for the life of the loan or can reset annually on each July 1 (See Table 1). However, the effective yield earned by loan holders on FFELP loans is tied to the quarterly SAP calculation. This calculation is a function of the 90-day Commercial Paper[8] rate plus a spread. Consequently, through the SAP calculation, FFELP loans are effectively converted to floating-rate assets, eliminating the need for interest rate swaps to be included in FFELP loan transactions.

Table 1

Rating Category	Stress Multiples
AAA	3.0x - 4.0x
AA	2.5x - 3.0x
A	1.5x - 2.5x
BBB	1.0x - 1.5x
BB	0.0x - 1.0x

For loans disbursed prior to April 1, 2006, when the borrower rate is greater than the SAP rate, the loan holder is allowed to keep the difference, which is called floor income. (See Chart 1 below for a graphic example of floor income.) For loans disbursed on or after April 1, 2006, amounts that would otherwise be floor income to the loan holder must be rebated to the ED.

Chart 1: Example of Floor Income



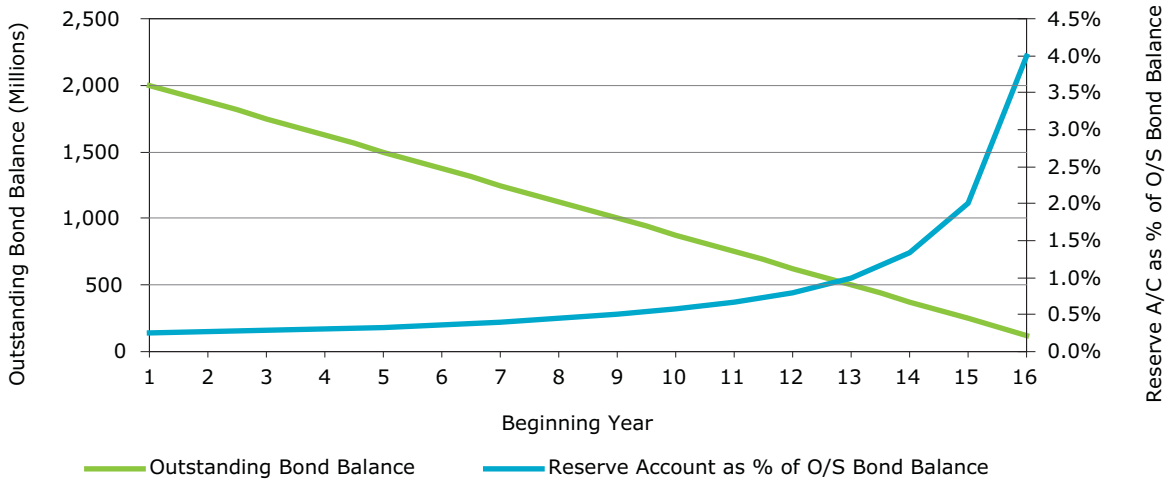
RESERVE ACCOUNTS AND CAPITALIZED INTEREST ACCOUNTS

Some loans included in a FFELP loan pool may not generate interest and principal cash flow due to the students' in-school statuses or their use of deferments or forbearances. Also, FFELP loans can have long periods of delinquency; under the FFELP guidelines loans do not default until they are 270 days past due. Consequently, FFELP loan transactions are often structured with reserve accounts and capitalized interest accounts. These accounts are used to provide liquidity support to trusts when a portion of the loans are not cash flowing and to also cover interest and principal shortfalls caused by loan delinquencies and defaults.

8. The federal government guarantees loan holders a "market rate of return" by paying them the difference between the interest income generated by the FFELP loans (i.e. the borrower rate) and the SAP rate. For FFELP loans made prior to January 1, 2000, the SAP Rate is calculated using the bond equivalent rate of 91-day Treasury bills.

Reserve accounts are factored into overall credit enhancement levels and are usually: (1) fully funded at the time a transaction is closed, (2) often sized as a percentage of the outstanding loan pool or bond balance, and (3) replenished on future distribution dates from available funds. Amounts in the reserve accounts are usually restricted to covering periodic note interest shortfalls and note principal shortfalls at maturity. Declining reserve accounts, often sized from 0.25% to 3.00% of either the current loan pool or bond balance, always contain a floor amount equal to a specified dollar amount. The specified dollar amount of the floor may represent a percentage of the initial pool balance and, when that amount is substantial, can provide increased credit enhancement to the trust as the transaction amortizes. (See Chart 2 below.)

Chart 2: Sample Reserve Account Analysis



Capitalized interest accounts are sized to reflect the amount of borrower interest expected to be capitalized by borrowers who are not in active repayment status. Amounts in capitalized interest accounts: (1) may be used to cover transaction fees and interest shortfalls, (2) are always fully funded at closing at specified dollar amounts, and (3) usually step down in size over the first few years of the transaction. Amounts drawn from capitalized interest accounts are generally not replenished from available funds.

NOTE TRIGGERS

FFELP loan securitizations often include note triggers, or deal covenants, to further protect senior noteholders against deteriorating collateral pools. Note triggers are generally tied to a transaction's parity levels, or targeted enhancement or overcollateralization levels. When in effect, note triggers most often redirect subordinate note principal and interest to the payment of additional senior note principal in order to de-lever transactions and build parity. Note triggers usually turn off when requisite parity levels are restored or specified credit enhancement levels are reached.

PREFUNDING

Some FFELP loan transactions provide for a prefunding period, during which a portion of note issuance proceeds is invested in eligible investments until funds are used to acquire collateral at a future date. Prefunding periods can be as short as one month and as long as a year or more. Often, prefunding periods are used to address the uneven origination flow in the student loan market that stems from the spikes in loan disbursements at the beginning of each academic semester.

RECYCLING

Recycling allows a trust to reinvest student loan principal receipts into new FFELP loan collateral. This feature is often used in master trust structures, where the initial recycling period is set at one to three years. The recycling period is often continually extended upon expiration, which usually requires rating agency confirmation of the ratings on the outstanding notes.

Loan Sourcing and Origination

LOAN SOURCING

FFELP loans are sourced through two main channels, school financial aid offices and direct-to-consumer marketing. The majority of undergraduate (Stafford and PLUS) loans are sourced through the school channel, although many lenders use retail marketing efforts to supplement their school origination channels. Consolidation loans are, for the most part, sourced through the direct-to-consumer channel because originations of Consolidation loans occur after students have graduated.

For many students, parents of students and schools, the financial aid office is the primary source of information for student loans and serves as the intermediary for obtaining loans. Financial aid administrators (FAAs) often maintain "preferred lender" lists and typically refer students and parents of students to lenders who have established relationships with the schools' financial aid offices. For this reason, along with increasing demand for student loans resulting from rapidly increasing tuition rates, the school channel remains the dominant source of FFELP loans.

ORIGINATION

There is minimal traditional credit underwriting applied to the origination of FFELP loans. The basic set of borrower eligibility criteria is dictated by the federal regulations governing the program and, in general, requires the borrower to be at least 18 years of age, be a U.S. citizen or eligible non-U.S. citizen, enrolled or admitted for enrollment at an eligible institution, and carry or plan to carry at least a half-time workload. For subsidized Stafford loans, for which the U.S. government pays loan interest while borrowers are in school or deferment, there is a "needs" test.[9] However, borrowers are still eligible for unsubsidized Stafford loans up to the aggregate FFELP loan limit. Loan limits for all FFELP loans are included in Table 2 below. For PLUS loans, which are extended to parents, there cannot be a derogatory on a parent's credit report.

Table 2

	Dependent Undergraduate Student	Independent Undergraduate Student	Graduate / Professional Student
1st Year	$2,625	$6,625	$18,500
2nd Year	$3,500	$7,500	$18,500
3rd & 4th Years (each)	$5,500	$10,500	$18,500
Maximum Total	$23,000	$46,000	$138,500*

* Includes undergraduate loans.

Servicer Risk

FFELP loans can lose their guarantee in the event of improper servicing. Therefore, the servicing of FFELP loans is critical to the overall performance of the FFELP loan collateral pool. As a result, DBRS conducts a review of the FFELP loan servicer's operations and servicing capabilities in connection with the transaction rating process (as outlined in Operational Risk Assessment for ABS servicers dated June 2011).

9. To determine the amount of subsidized Stafford loans a borrower can obtain, the ED uses a "needs test" that is based on the amount of Expected Family Contribution (EFC) the borrower can apply to the cost of attendance, the amount of other federal and non-federal aid available to the borrower and other demographic factors.

Analysis of Expected Loss

All FFELP loan securitization transactions must pass cash flow scenarios that stress the performance of the actual collateral pool to be securitized, as well as the transaction's legal and capital structure. The DBRS rating methodology uses assumptions addressing default frequency, default timing and loss severity to stress the expected cash flows of a transaction.

DEFAULT FREQUENCY

In the DBRS rating analysis, the collateral pool is stratified by key loan and school type characteristics. Loan types primarily include subsidized Stafford, unsubsidized Stafford, PLUS, Grad PLUS and Consolidation. School types include four-year public, four-year private, two-year public, two-year private, vocational or proprietary and graduate. Static pool historical default data, similarly stratified, is used to determine base case loan default expectations for each loan type and school type. For the cash flow stress scenarios, DBRS provides the issuer with default rate assumptions reflecting the distinct characteristics of loans in the collateral pool.

Ideally, the static pool data will be issuer-specific and include several years' of repayment history. However, given that all FFELP loans are originated based on homogeneous underwriting criteria and processes, default frequencies[10] do not vary widely among lenders. Consequently, when using historical default data to derive default assumptions, DBRS will have the option of using either a universal FFELP default model that incorporates a blend of static pool data from multiple loan originators or issuer-specific data sets.

Once a base case gross default assumption and standard deviation for the pool are determined, the base case is then stressed depending on the desired tranche rating (e.g., the higher the tranche rating, the more onerous the stress) as shown in Table 3 below:

Table 3

Rating Category	Stress Multiples
AAA	3.0 - 4.0
AA	2.5 - 3.0
A	1.5 - 2.5
BBB	1.0 - 1.5

The stress multiples in Table 3 above reflect the number of standard deviations at each rating category that are added to the base case assumption.

Unique loan pool characteristics, such as geographic concentration, may also affect portfolio performance, and therefore may be addressed in the collateral analysis through adjustments to the base case default assumption or application of standard deviations to the base case.

In order for DBRS to evaluate the level of seasoning credit that may be applied to a pool, the transaction issuer must provide DBRS with pool stratifications detailing the loans' original terms, remaining terms and number of months in repayment. When DBRS applies seasoning credit, total expected defaults for a FFELP loan portfolio may be adjusted depending on the level of actual pool losses incurred to date, the timing of those losses as expected by the DBRS default curve and the remaining life of the pool loans.

10. Under the FFELP, if a student loan is serviced properly and becomes 270 days delinquent, a loan holder can submit to a designated guarantor (reinsured by the ED) a claim for reimbursement of defaulted principal and accrued interest up to the guarantee percentage of the loan. The guarantee percentage of the loan depends upon the origination date of the loan.

In student loan portfolios, defualt assumptions are very sensitive to seasoning credit as the default curve is front-loaded (see Default Timing Curve below). Therefore, loan seasoning data must be sufficiently reliable for DBRS to consider giving seasoning credit to a pool.

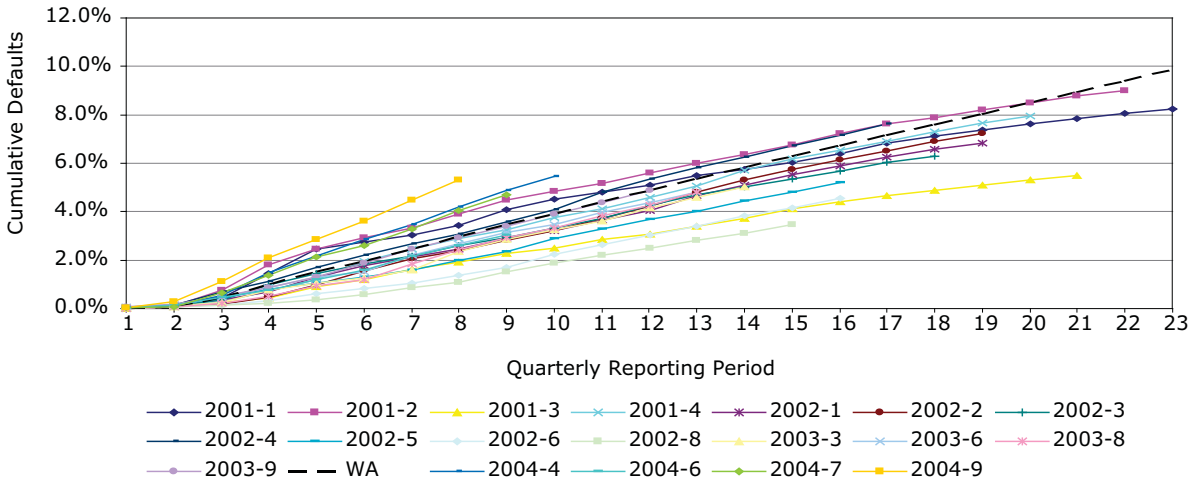
DEFAULT TIMING

The default curve (i.e., timing of defaults) for FFELP loans varies by loan product. For example, the default curve for Stafford loans is steep due to the profusion of first-pay and early-stage defaults. Many defaults on Stafford loans occur early in the repayment period because borrowers are recent graduates that may not yet have obtained gainful employment and may also have limited experience managing their personal debt. Conversely, the default curve for Consolidation loans is flatter. Through consolidation, borrowers lower their monthly payments by extending the loan terms, thus easing their debt burden. The curve for PLUS loans is similarly flat. PLUS loans are made to students' parents, who most often are gainfully employed and have experience managing personal debt.

DBRS uses two distinct default curves for Stafford loans and for Consolidation and PLUS loans. The curve for Stafford loans spreads defaults over three years (70%/20%/10%), and the curve for Consolidation and PLUS loans spreads defaults over four years (40%/30%/20%/10%). Since Grad PLUS is a new product as of July 1, 2006, the more conservative Stafford loan default curve is being applied to those loans. Once the defaults for a given period have been determined based on the aforementioned allocation, defaults are then evenly spread within each period. DBRS may, on a case by case basis, adjust the loss curve to reflect anomalies in a specific loan pool.

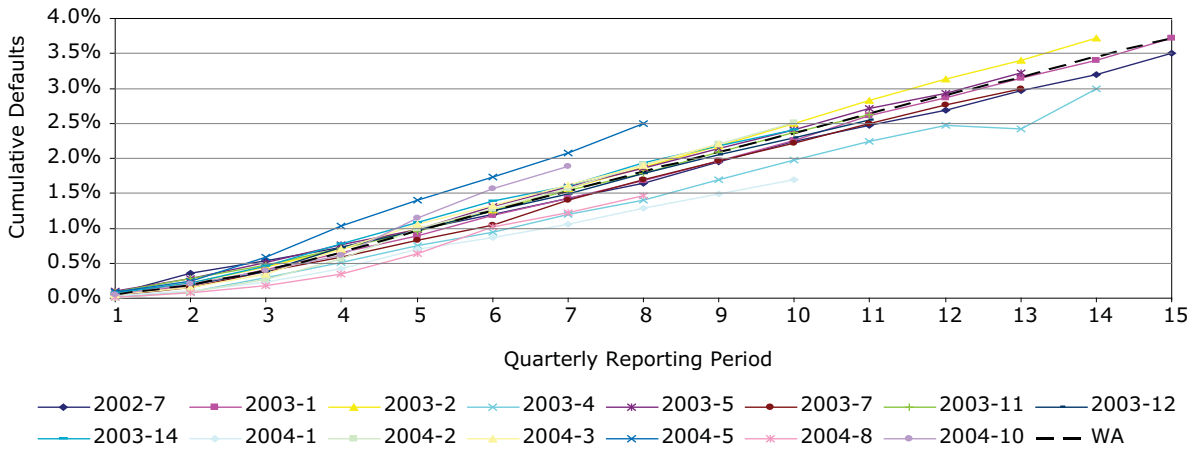
Charts 3 and 4 show the cumulative default performance for Sallie Mae FFELP loan trusts. The trusts contain loans in various statuses and stages of repayment and do not represent vintage year cohorts; therefore, default speeds depicted in chart 3 and chart 4 may be slower or faster than that of actual vintage cohorts.

Chart 3: SLM Student Loan Trust Non-Consolidation Loan Cumulative Defaults



Source: Sallie Mae.

Chart 4: SLM Student Loan Trust Consolidation Loan Cumulative Defaults



Source: Sallie Mae.

LOSS SEVERITY

Loss severity rates in FFELP loan pools tend to be low due to the ≥97% guarantee level on FFELP loans. However, FFELP loans can lose their guarantee if they are improperly originated or serviced. Consequently, the DBRS analysis includes an additional and separate loss assumption that addresses the risk that a defaulted loan will be ineligible for the guarantee due to improper origination or servicing. In the cash flow stress scenarios, credit is not given to the maximum (99%) claims reimbursement to which servicers designated as Exceptional Performers are entitled because the status must be renewed on an annual basis and may be revoked at any time.

To arrive at collateral loss assumptions that stem from improper origination or servicing procedures, DBRS analyzes a servicer's historical "net claim reject" experience. This statistic captures the amount of defaulted loan claims that are rejected by the guarantor due to non-curable servicing or origination errors. Based upon a review of the net claim reject data, DBRS calculates an average net claim reject rate from the data along with the standard deviation for the data set. When the servicer net claim reject data is unavailable or insufficient, DBRS uses standard servicer loss rates derived from an analysis of data from multiple servicers and applies more conservative stresses in the assumptions.

In the DBRS cash flow scenarios, the servicer loss rate equals the average net claim reject rate plus a certain number of standard deviations based on the desired tranche rating. Across FFELP loan servicers, net claim reject rates generally are less than 1%, and many are mere basis points. Consequently, the servicer loss rates applied by DBRS are relatively low and spread within a tight band (see Table 4).

Table 4

Rating Category	Servicer Loss Rate
AAA	2.00%
AA	1.75%
A	1.25%
BBB	0.75%

Other Factors Impacting FFELP Loan Cash Flows

The degree of loss severity for FFELP loans benefits from the non-dischargeablity of FFELP loans in bankruptcy. An exception to non-dischargeability is undue borrower hardship. This exception, however, has rarely been applied.

Factors other than defaults also impact cash flows in FFELP loan securitizations. Some of these factors are generic to all ABS (e.g. prepayments, revolving periods, prefunding periods, timing lags on recoveries, interest rate and basis risk etc.). Certain factors are unique to student loans, such as mandatory grace periods, deferment and forbearance options, borrower benefit programs, the use of loan principal recycling and timing lags on the receipt of government interest subsidies and guarantee claim reimbursements.

PREPAYMENTS

FFELP loan prepayments typically occur for the following reasons: (1) borrowers consolidate their Stafford (and/or PLUS) student loans; (2) guarantors remit reimbursements on defaulted loan claims; (3) borrowers accumulate funds and pay off their loans; (4) borrowers refinance their loans with other forms of personal debt; and (5) servicers purchase defaulted loans when claims are rejected by guarantors.[11]

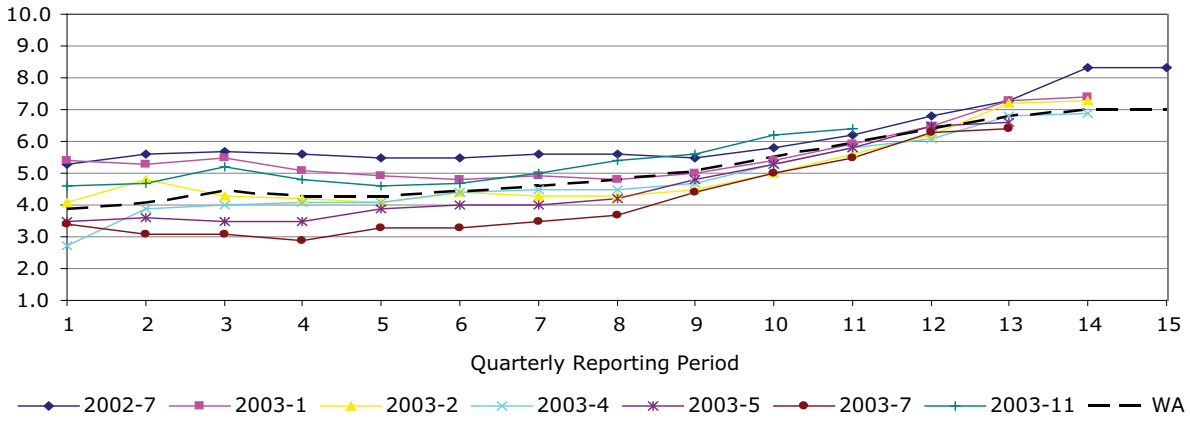
Historically, annualized prepayment speeds, or Constant Prepayment Rates (CPRs), on Stafford loan pools have been as high as 60%, due primarily to the financial attractiveness of loan consolidation. Conversely, prepayment speeds for trusts backed only by Consolidation loans have been significantly lower, due to the very limited opportunities to reconsolidate the loans or refinance the loans at more attractive terms. Given the significant difference in the prepayment speeds for Stafford and Consolidation loans, DBRS uses distinct prepayment assumptions for transactions backed by a majority of Consolidation loans and for those backed by a majority of Stafford loans.

If available, DBRS uses prepayment speeds in the cash flow scenarios that are issuer specific. Nevertheless, the prepayment assumption for FFELP Consolidation loan securitizations will typically be a ten-year ramp from 0%–8%. For non-Consolidation loan trusts, the prepayment assumption will typically be a flat rate CPR of at least 9.0% from deal inception.

The following graphs (Charts 5 and 6) illustrate the since-issued CPRs for select Sallie Mae FFELP loan trusts.

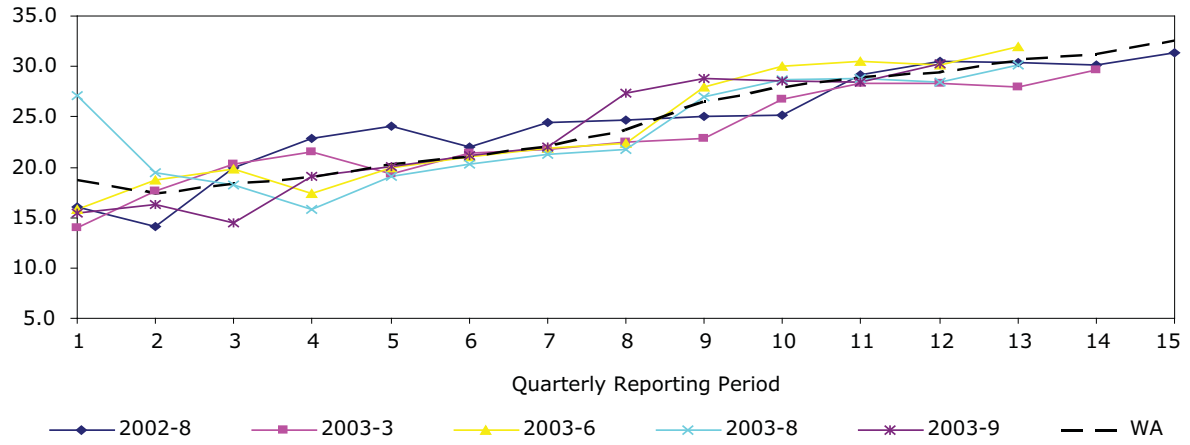
11. In most FFELP securitizations, servicers are obligated to purchase defaulted loans when default reimbursement claims to guarantors have been rejected for servicing errors. DBRS does not generally give credit to this obligation because, in general, FFELP servicers are not rated entities.

Chart 5: SLM FFELP Consolidation Loan Trust Since-Issued CPRs*



*Constant Prepayment Rate. Since-Issued CPR is a measure of the current period's ending pool balance versus the current period's pro projected pool balance calculated as of the statistical cut-off date.
Source: Sallie Mae.

Chart 6: SLM FFELP Non-Consolidation Trust Since-Issued CPRs*



*Constant Prepayment Rate. Since-Issued CPR is a measure of the current period's ending pool balance versus the current period's projected pool balance calculated as of the statistical cut-off date. Source: Sallie Mae.

BASIS RISK/INTEREST RATE RISK

Interest rate risk in FFELP loan securitizations exists in the form of index risk and reset risk. A base forward curve is used to address both types of risk.

Index Risk

The SAP calculation (see Floor Income section above) effectively converts FFELP loans to floating-rate assets indexed to either the 90-day CP rate, or the 91-day T-bill rate, plus a margin. Typically, the coupons for the FFELP loan securitization trust liabilities are indexed to LIBOR or an auction-rate (most commonly either 28-day for taxable securities or 35-day for tax-exempt securities) or set at a fixed rate. This mismatch in interest indices creates basis risk in the form of index risk.

In the cash flow stress scenarios, DBRS addresses index risk by stressing the relationship between indices over the duration of the transaction. The stress scenarios are derived from the historical relationship observed for the indices over a ten-year period. The average basis gap is either widened or compressed at each rating category by standard deviations of the historical average. The standard deviations span at least 1.00 at the BBB level to up to 4.00 at the AAA level.

Reset Risk

SAP is calculated and paid quarterly, and subject to a 45-day payment lag. Although trust liabilities may be payable quarterly, their payment schedule may differ from the SAP schedule, or they may be payable monthly or weekly. This timing mismatch of when interest payments are calculated versus paid creates basis risk in the form of reset risk.

Reset risk is addressed by stressing the base rate LIBOR forward curve, from which both the asset and liability interest rates are determined. For auction-rate securities, which may have rates that reset anywhere from seven to 90 days, DBRS uses the forward curve that best matches the transaction liabilities (e.g. one-month LIBOR for 28- and 35-day auction rate notes).

To the extent that FFELP loan securitizations contain fixed-rate liabilities, further interest rate stresses are applied to address duration mismatches.

GRACE, DEFERMENT AND FORBEARANCE

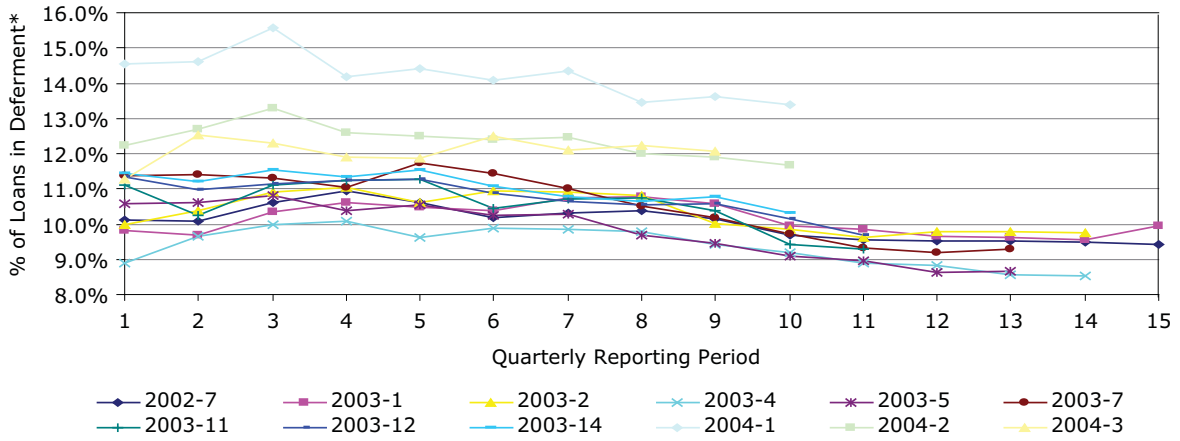
When borrowers of **subsidized** Stafford loans are in school and in grace status (i.e., six months following graduation or having ceased being enrolled in at least a half-time program of study), interest is paid by the federal government to loan holders on behalf of borrowers. During these same periods, borrowers of **unsubsidized** Stafford loans must pay monthly loan interest or have it capitalized upon entering repayment. Borrowers of PLUS, Graduate PLUS and Consolidation loans are required to begin repayment of interest and principal beginning 60 days after the final disbursement of the loans.

Deferment and forbearance options are available to all FFELP loan borrowers during the repayment period. Deferment is typically reserved for students returning to school for further education or to borrowers enlisting in the military. Forbearance is generally granted to borrowers in times of economic hardship. During deferment, interest is paid by the government on behalf of borrowers of only **subsidized** Stafford loans and on the **subsidized** portion of Consolidation loans. During forbearance, all interest must be paid or capitalized.

Although DBRS views the use of grace periods, deferment and forbearance periods as beneficial to securitizations because they serve as default aversion tools, their use increases liquidity risk. This risk is typically addressed by requiring adequate amounts in reserve accounts and capitalized interest accounts to be available to cover interest shortfalls (See Reserve Account section).

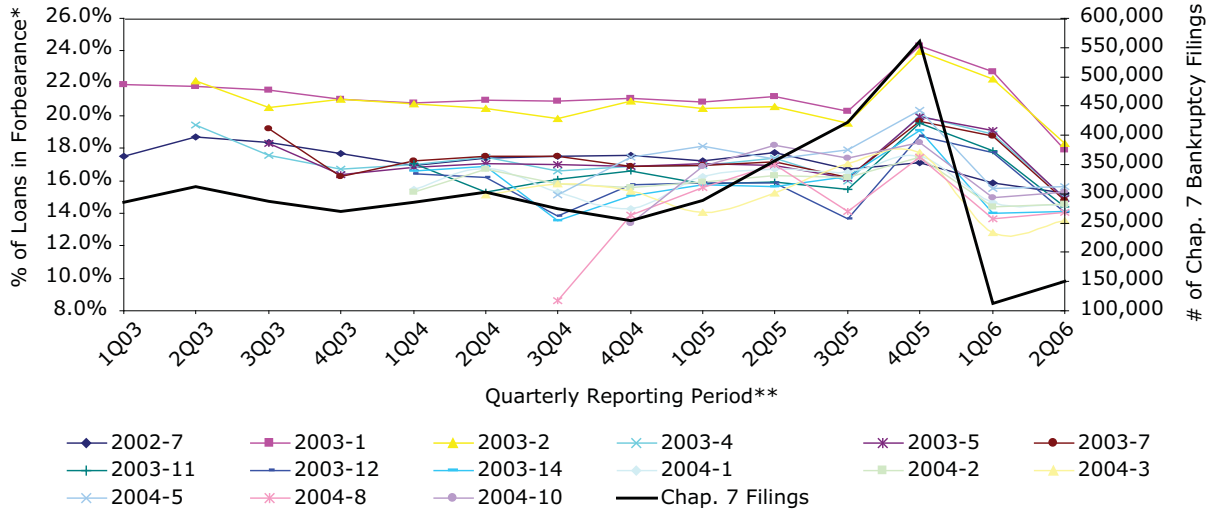
Charts 7 and 8 show deferment and forbearance volume within Sallie Mae FFELP loan trusts containing 100% Consolidation loans. Charts 9 and 10 below show deferment and forbearance volume within Sallie Mae FFELP loan trusts containing 100% Stafford and PLUS loans. Since forbearance is granted primarily for economic hardship, Charts 8 and 10 include the level of bankruptcy filings for each corresponding quarterly distribution period.

Chart 7: SLM Student Loan Trust Consolidation Loan Deferment



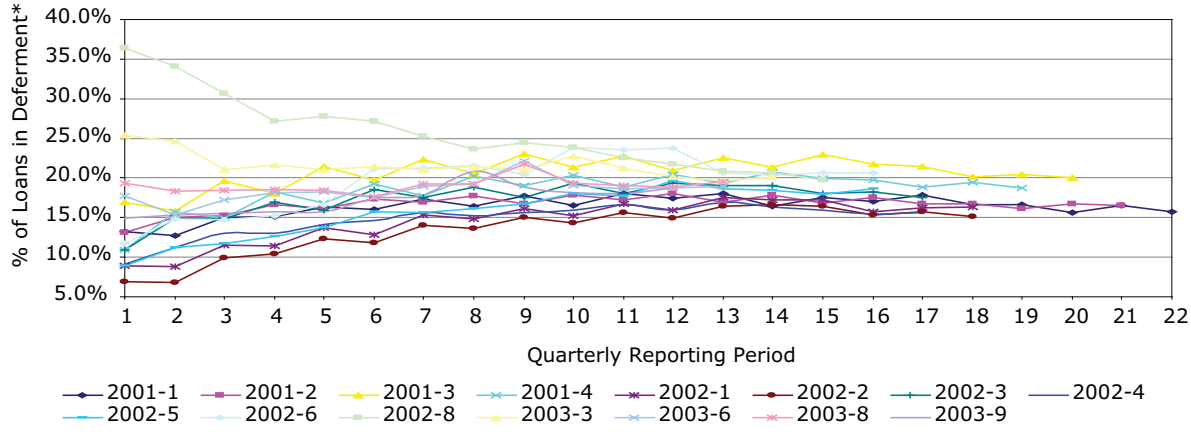
* Includes only loans that have reached repayment status. Source: Sallie Mae.

Chart 8: SLM Student Loan Trust FFELP Consolidation Forbearance



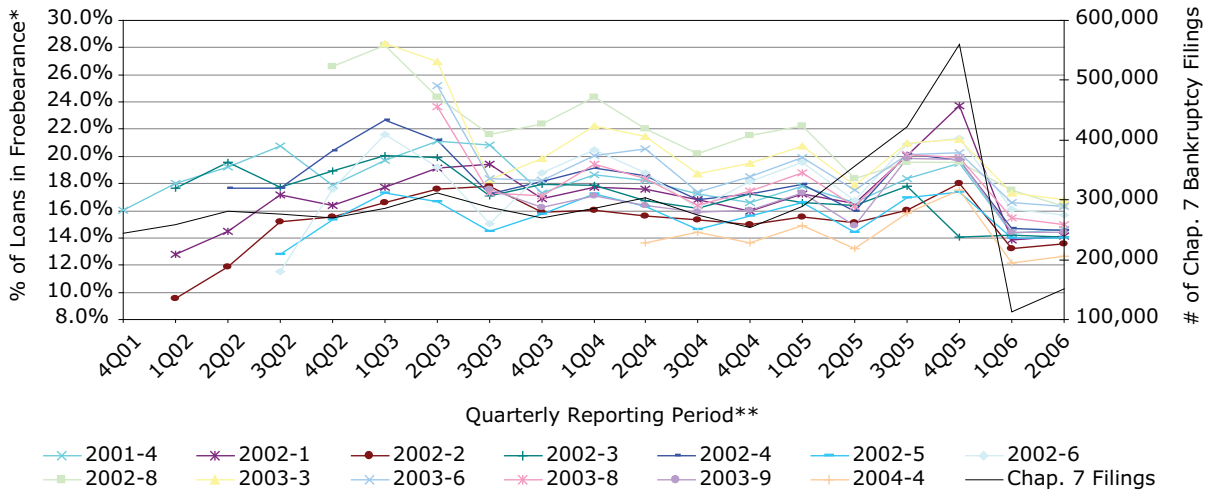
* Includes only loans that have reached repayment status. **Sallie Mae Quarterly Reporting Periods throught 2003-1 2 are February, May, August, November. Source: Sallie Mae; Administrative Office of the U.S. Courts.

Chart 9: SLM Student Loan Trust FEELP Non-Consolidation Deferment



* Includes only loans that have reached repayment. Source: Sallie Mae.

Chart 10: SLM Student Loan Trust FFELP Non-Consolidation Forbearance



* Includes only loans that have reached repayment. **Sallie Mae Quarterly Reporting Periods throught 2003-12 are February, May, August, November. Source: Sallie Mae; Administrative Office of the U.S. Courts.

DBRS requires FFELP loan ABS issuers to furnish comprehensive data with respect to their historical utilization rates for deferment and forbearance, including loan volumes and lengths of time in each status. DBRS prefers to rely on issuer-specific historical data to derive cash flow assumptions regarding deferment and forbearance utilization rates. In the event issuer-specific data is unavailable or insufficient, DBRS may use standard assumptions derived from data representing a compilation of other loan originators' experiences and apply more conservative stresses in the resulting assumptions.

Deferment and forbearance utilization assumptions are stressed in DBRS cash flow scenarios at each rating category based on the desired tranche rating, using the base case observation plus standard deviations to the base case (see Table 3 above on page 8). The duration of utilization for each status is also stressed incrementally at each rating category. Table 5 below illustrates the length of time DBRS assumes loans will remain in deferment and forbearance statuses in the cash flow scenarios. Table 5 represents sample assumptions for an issuer that has demonstrated historically that loans in deferment have remained in such status for an average of 12 months and loans in forbearance have remained in such status for an average of nine months. Assumptions are adjusted accordingly for each transaction.

Table 5

Rating Category	Deferment Months	Forbearance Months
AAA	30	27
AA	24	21
A	18	15
BBB	12	12

BORROWER BENEFITS

Borrower benefits typically offered by FFELP lenders include one or more of the following: (1) interest rate reductions for scheduling automatic payments; (2) interest rate reductions for consecutive on-time monthly payments; and (3) principal rebates for program completion or other qualifications. Some lenders also offer loan forgiveness for teachers and nurses practicing within a specific state or region for a minimum period of time.

Borrower benefits can impact the cash flow of a FFELP loan transaction by reducing collateral yields and principal balances. Consequently, DBRS requests originators to furnish comprehensive information on borrower benefit programs that may affect loans in the collateral pool. Similar to its approach for deferments and forbearance, DBRS develops assumptions with respect to borrower benefit utilization rates based on the historical experience and then stresses these assumptions based on the desired rating for a class of notes.

BORROWER DELINQUENCIES

Borrower delinquencies are factored into the cash flow stress assumptions primarily due to their impact on borrower benefit utilization rates, forbearance and deferment rates and late fees.

Borrower Benefit Utilization

To qualify for borrower benefits, borrowers are often required to have payment histories containing no delinquencies. When an issuer's FFELP loan program includes borrower benefits that are granted based on a borrower's lack of delinquency status, DBRS looks primarily to the lender's historical delinquency experience in connection with stressing borrower benefit utilization rates. DBRS uses delinquency assumptions for three delinquency buckets —current, 30-days delinquent and 60-days delinquent. With respect to the current bucket, DBRS assumes that more borrowers are current. This results in more borrowers qualifying for the borrower benefit, which reduces the collateral cash flow. The DBRS standard delinquency assumptions are presented in Table 6 below.

Table 6

No Borrower Benefits (or paid outside of the trust):

Stafford Loans

Rating Category	Current	30-Days Delinquent	60-Days Delinquent
AAA	20%	35%	45%
AA	30%	30%	40%
A	40%	25%	35%
BBB	55%	20%	25%
BB	60%	20%	20%

PLUS and Consolidation Loans

Rating Category	Current	30-Days Delinquent	60-Days Delinquent
AAA	35%	35%	30%
AA	45%	30%	25%
A	55%	25%	20%
BBB	65%	20%	15%
BB	70%	20%	10%

Borrower Benefits (paid inside of the trust):

Stafford Loans

Rating Category	Current	30-Days Delinquent	60-Days Delinquent
AAA	60%	20%	20%
AA	55%	20%	25%
A	40%	25%	35%
BBB	30%	30%	40%
BB	20%	35%	45%

PLUS and Consolidation Loans

Rating Category	Current	30-Days Delinquent	60-Days Delinquent
AAA	70%	20%	10%
AA	65%	20%	15%
A	55%	25%	20%
BBB	45%	30%	25%
BB	35%	35%	30%

Deferment and Forbearance Rates

Delinquency statistics for student loan programs that offer deferment and forbearance may understate the amount of non-cash flowing loans in a pool. Lenders and servicers often steer delinquent borrowers into deferment or forbearance statuses to avoid further delinquency and borrowers in those statuses are generally not included in the delinquency roll data. Therefore, when formulating liquidity stress assumptions, and specifically delinquency rates, DBRS considers the number of borrowers in deferment and forbearance statuses to properly analyze the loan pool. Standard delinquency assumptions may, therefore, be adjusted on a deal-by-deal basis depending on the type and quality of the data provided by the issuer.

Late Fees

Delinquent borrowers are often charged late fees by lenders. However, DBRS provides credit for no more than 50% of late fees expected to be collected by lenders in its cash flow scenarios. The inclusion of late fees in the DBRS cash flow analysis is determined on an issuer-by-issuer basis and is impacted by the amount of late fees charged by the lender and the degree to which a servicer has discretion to waive late fees. Ideally, the data provided by the issuer will determine what amount of late fees, if any, may be included in the DBRS cash flow scenarios.

Payment Lags

Although the processes for the ED to make interest subsidy and SAP payments and guarantors to make claim reimbursement payments are dictated by federal regulations, the possibility exists that receipt of payments can be delayed beyond the proscribed time frame. Although the ED has never missed an interest subsidy or SAP payment, DBRS assumes a modest lag of 60 additional days for the receipt of such payments.

Guarantors[12] are required to reimburse loan holders on claims for defaulted FFELP loans within 90 days of receipt of the claim. DBRS assumes a range for the lag in the receipt of default claims reimbursement payments beyond the mandated 90 day time limit (see Table 7).

Table 7

Rating Category	Claim Reimbursement Lag
AAA	210 days
AA	180 days
A	150 days
BBB	120 days

PREFUNDING

The use of prefunding periods can expose a FFELP loan securitization to negative carry risk and can erode excess spread. In the cash flow stress assumptions, DBRS may haircut the amount of loans originated during the prefunding period. If no future flow agreement exists and the issuer cannot demonstrate a strong origination history themselves, DBRS may require that 100% of the prefunding amount be held in cash or eligible investments (i.e. not used to purchase new loans) for the duration of the prefunding period. Further, if the transaction documents permit new collateral to be purchased at a premium, DBRS requires that all new collateral be purchased at the highest premium permitted in the documents.

RECYCLING

The use of recycling can cause collateral pool characteristics to change over time. In the absence of specific restrictions in the transaction documents as to what types of loans a trust can recycle into, DBRS may assume that all recycling amounts are used to purchase new first-year Stafford loans, which have the highest risk for prepayment and default and the longest in-school and grace periods.

12. Guarantors are generally not-for-profit entities and therefore have low default risk.

Legislative Risk

The FFELP exists as part of Title IV of the *Higher Education Act of 1965* (the HEA). As a federal law, the HEA can be changed at any time. Also, the HEA contains a sunset provision that requires periodic reauthorization every five years. Historically, reauthorization has occurred every six to seven years, and changes to the FFELP have coincided with reauthorization. As a result, the FFELP loan securitization market is subject to the risk of future legislation that changes the terms of the FFELP. Although, HEA reauthorization has never implemented retroactive changes to the FFELP, prospective changes to the program can have a retroactive affect on existing FFELP loan transactions and, from a broad market perspective, can affect the economics of future FFELP loan transactions vis-à-vis past FFELP loans transactions. As a result, DBRS monitors legislative developments closely and makes any necessary modifications to rating criteria when necessary.

Conclusion

The FFELP provides the U.S. capital markets with an ever-increasing volume of stable, yet complex, loan collateral. To aid issuers and investors, DBRS has developed a comprehensive FFELP loan securitization ratings methodology. This methodology considers the most important characteristics of FFELP loan products, the unique risks inherent in them, and the most common structural elements of financing this type of collateral. DBRS continues to monitor developments in the FFELP student loan sector and make modifications to the rating criteria when necessary and in a timely manner.

For a summary of key DBRS rating criteria applied to FFELP student loan transactions, see Appendix A.

Appendix A

The following two tables summarize key assumptions utilized in the DBRS ratings approach to FFELP student loan transactions. Scenario 1 assumptions address the absolute level of transaction cashflows from a fundamental perspective. These factors influence the likelihood that principal and interest payments will be made on the FFELP loan securitization notes. Scenario 2 assumptions address extension risk.

Scenario 1

Transaction Characteristic	Rationale	Stress
Cumulative Gross Collateral Default Rates	Increase levels of defaults to reduce collateral cash flow; reduce parity; increase prepayments on insured loans	Apply standard deviations to base cases derived from historical loan data; range from 1.5-2.0 at BBB to 3.0-4.0 at AAA
Default Timing	Front-load frequency to reduce collateral yield and increase prepayments on insured loans	Compress timing to 70%/20%/10% for Stafford loans and 40%/30%/20%/10% for Consolidation loans; spread evenly within each year
Servicer Loss Rates	Reduce collateral balance	Apply standard deviations to base cases derived from historical data; range from 0.75% to 2.00%
Prepayment Rates	Reduce parity; increase extension risk	Run pricing CPR in unexceptional circumstances
Collateral Delinquency Rates	Reduce collateral yield	For loans with payment-dependent benefits, apply lower standard deviations to base cases derived from historical loan data; for loans without payment-dependant benefits, apply higher standard deviations to base cases
Government Payment Lags	Reduce collateral yield	Lag interest subsidies and SAP payments 60 days
Claims Reimbursement Lags	Reduce collateral yield	Lag default claim reimbursements; range from 120 days at BBB to 210 days at AAA
Deferment and Forbearance Utilization Rates	Reduce collateral yield	Apply standard deviations (lower than in Scenario 2) to base cases derived from historical loan data; range from 1.5–2.0 at BBB to 3.0–4.0 at AAA
Borrower Benefits Utilization Rates	Reduce collateral yield/balances	Apply standard deviations (higher than in Scenario 2) to base cases derived from historical loan data; range from 1.5–2.0 at BBB to 3.0–4.0 at AAA
Prefunding	Reduce collateral yield	Hold prefunding amounts until end of period, or haircut acquisition amounts
Recycling	Reduce collateral yield	Recycle into loans with highest default and prepayment risk
Servicer Cost Inflation	Reduce collateral yield	Increase at historical CPI
Interest Rates	Increase cost of funds; increase basis risk	Apply base rate ramp; increase basis gap by standard deviations from base cases of historical spread relationships
Reinvestment Rates	Reduce collateral yield	3mL -25bps; 1mL -15bps; or GIC rate
Failed Auctions	Increase cost of funds	Range from one failed auction each year at AAA to failed auction every four years at BBB

Scenario 2†

Transaction Characteristic	Rationale	Stress
Recycling	Extend WAL	Recycle into new, longer term loans

Prepayment Rates	Maintain parity; extend WAL	Run reduced CPR
Collateral Delinquency Rates	Match base case expected delinquency experience	Apply standard deviations (lower than in Scenario 1) to base cases
Deferment and Forbearance Utilization Rates	Extend loan terms; increase loan balances through interest capitalization	Apply standard deviations (higher than in Scenario 1) to base cases; range from 1.5–2.0 at BBB to 3.0–4.0 at AAA
Borrower Benefits Utilization Rates	Match base case expected utilization	Apply standard deviations (lower than in Scenario 1) to base cases; range from 1.5–2.0 at BBB to 3.0–4.0 at AAA
Interest Rates	Increase cost of funds; increase basis risk	Apply base rate ramp; increase basis gaps by standard deviations from base cases of historical spread relationships

† Note: no collateral defaults occur in scenario 2; Servicer Cost Inflation increases, Interest Rate stresses, and Reinvestment Rates are the same as in Scenario 1.

Appendix B

ILLUSTRATION OF CALCULATION OF PRINCIPAL DISTRIBUTION AMOUNT

The principal distribution amount is sometimes calculated with reference to the change in the trust's "adjusted pool balance" for the preceding distribution period versus the then current distribution period. The adjusted pool balance concept operates as a mechanism to step-up credit enhancement in the latter stages of the transaction. After the collateral pool has amortized more than a targeted amount, say 40%, the amount on deposit in the reserve account is no longer included in the adjusted pool balance, thus increasing the amount of student loan collections to be distributed to achieve the targeted parity level and accelerating the amount of senior notes to be redeemed. The effect of this circumstance is that the reserve account becomes a larger percentage of credit enhancement for the remaining outstanding bonds; and in the latter stages of the transaction the subordinate bonds stand to benefit the most. (See Table below for an example of the Adjusted Pool Balance Concept.)

Example of Adjusted Pool Balance Concept and Step-up of Credit Enhancement

Before 40% Amortization Trigger:

	Previous Distribution Period	Current Distribution Period
Loan Principal Balance	$100	$80
Reserve Account Balance Included in APB	$10	$10
Bond Balance to Maintain 100% Parity	$110	$90
Amount of Principal Distribution	–	$20
Reserve Account % of Remaining Bonds	9.1%	11.1%

After 40% Amortization Trigger:

	Previous Distribution Period	Current Distribution Period
Loan Principal	$100	$80
Reserve Account Balance Included in APB	$10	–
Bond Balance to Maintain 100% Parity	$110	$80
Amount of Principal Distribution	–	$30
Reserve Account % of Remaining Bonds	9.1%	12.5%

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www.dbrs.com

New York
140 Broadway
35th Floor
New York, NY 10005
TEL +1 212 806 3277